Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3400

June 19, 2006

AGENDA ITEM 6a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Manager Development Program (MDP) I and II Annual Review

II. PROGRAM: Global Equity

III. RECOMMENDATION: Information only

IV. ANALYSIS:

Executive Summary

This agenda item will provide a review of CalPERS' Manager Development Program (MDP). The MDP annual review is presented in four sections: 1) MDP I Overview, 2) MDP I Partner Performance, 3) MDP I Individual Manager Performance, and 4) MDP II Update.

Since its inception in 2000, the MDP I program has experienced mixed performance results. While the private equity portion of the program has performed within staff's expectations, the investment portion has had less favorable long-term results. However, performance over more recent time periods has improved. Staff continues to work with both MDP I partners, Progress and Strategic, to address the underperformance through the reallocation of assets to better performing managers within the MDP I portfolio. The MDP I program funded 16 managers, 12 of which currently remain in the program.

The MDP II program is now active and staff is currently reviewing potential MDP II firms with CalPERS' two MDP II partners, Legato and Strategic. Legato will be an advisor to long-only emerging firms while Strategic will be an advisor to both long-only and hedge fund-of-fund firms. Three other firms remain in CalPERS MDP II partner pool. Staff anticipates funding three to five managers per year subject to the availability of qualified firms that both staff and the advisor believe will be successful.

Background

The MDP I, which began in May 2000, is an innovative program in which CalPERS provides venture capital and investment funds to emerging money management firms in exchange for a significant but minority equity stake in the selected firms. The investment period for new firm additions to MDP I ended March 31, 2004. CalPERS has two partners assisting staff in managing the MDP I program, Progress Lovell Minnick and Strategic Investment Management. The role of the MDP I partners is to: 1) identify and conduct due diligence on prospective MDP I firms, 2) negotiate the private equity investments, 3) monitor the portfolio performance, and 4) develop the MDP I firms. Attachment 1 provides further details on the background of this program.

At its August 16, 2004 meeting, the Investment Committee approved and delegated authority to staff to expand and improve the Manager Development Program (MDP) with the creation of the Manager Development Program II. In structuring MDP II, staff has implemented the following enhancements in the new program: 1) eliminate paying fees on committed capital, 2) eliminate a specific upfront capital commitment, 3) create an opportunistic and potentially infinite investment period, 4) require both staff and MDP II Advisor agreement on each investment, and 5) include emerging hedge fund-of-funds.

More information on the MDP II is included in section 4.

Section 1 – MDP I Overview

There are three distinct time periods or phases of the MDP I program: 1) the investment phase lasting the first three years, 2) the development phase, from years one through eight, and 3) maturity or exit phase, which is the last two to three years of the program. At six years into the program, the investment phase of the MDP I program is closed, discontinuing the option of adding new firms to the program. The focus of the program now is to develop the current MDP I firms and possibly begin the exit phase for some of the program's earlier investments.

Tables 1 and 2 illustrate: 1) the amount originally approved for investment by the Investment Committee and the actual dollar amount invested by each partner, and 2) the number of firms each partner has funded.

Table 1

Partner	Original Amount Allocated	Dollar Amount Invested
Progress Lovell Minnick	$1 billion	$ 850 million
Strategic Inv. Mgmt.	$2 billion	$1,650 million

Table 2

Partner	Firms Funded	Firms Graduated[1]	Firms Terminated[2]
Progress Lovell Minnick	8	2	3
Strategic Inv. Mgmt.	8	0	0

[1]One manager graduated outside the program while the other graduated to the mainstream program but continues to manage an MDP portfolio ;[2] Managers terminated due to performance and organizational issues

Section 2 - MDP I Partner Performance (excludes venture portfolios)

The performance objective of the Manager Development Program partners is to outperform their aggregate custom benchmark as shown in Table 3. The partners' custom benchmarks are an average weighted benchmark of the underlying managers' benchmarks for each of the products in the partners' portfolio. Over the 12 months ending April 30, 2006, Progress has outperformed its custom benchmark by 0.63%, and Strategic has underperformed its custom benchmark by 1.16%. On an annualized basis since inception through April 30, 2006 and net of management fees, Progress has underperformed its benchmark by 3.04% whereas Strategic has outperformed its benchmark by 0.85%.

Tables 3 and 4 illustrate the annualized returns for each MDP partner and each asset class and their respective benchmarks, net of MDP firm management fees, for periods ending April 30, 2006. The performance shown excludes the venture portfolios given that the average age of investments for the MDP managers is still early at only 3.8 years. The partners' past performance includes managers who have been terminated since inception of the MDP I program. Although the Strategic partnership currently holds a larger percentage of the MDP I portfolio with 74% of the assets, it is important to note the since inception performance illustrated in Table 4 is more reflective of initial stages of the program which were more heavily weighted towards the Progress partnership.

Table 3 - Annualized Return Performance ending April 30, 2006[1]

MDP I Partner	% of MDP Portfolio	YTD 2006[1]	Calendar Year 2005	Last 12 Months[2]	Annualized Since Inception[3]
Progress Lovell Minnick	26%	10.29%	8.06%	26.43%	-0.21%
Custom Benchmark		9.49%	8.87%	25.80%	2.83%
Active Return		**0.80%**	**-0.81%**	**0.63%**	**-3.04%**
Strategic Inv. Mgmt	74%	7.89%	7.44%	20.42%	7.02%
Custom Benchmark		7.79%	7.64%	21.58%	6.17%
Active Return		**0.10%**	**-0.20**	**-1.16%**	**0.85%**

[1] Performance is net of MDP firm management fees; [2] Through April 30, 2006; [3] Progress inception date 5/31/00. Strategic inception date 12/31/00.

Progress' overall investment portfolio is beginning to show signs of improvement over the past year as evidenced by the portfolio's most recent performance periods. Although the time period is short, the performance returns are a result of staff's rebalancing decisions that were taken over the past year. During the last 12 months, one manager was terminated, one manager graduated, and additional assets were reallocated among individual managers within the MDP I program.

Strategic's overall investment portfolio continues to perform within staff's expectations on a long-term basis. Over the most recent periods, the majority of the underperformance is attributed to the portfolio's exposure to international equity managers, which staff has recently addressed with rebalancing decisions.

The international equity underperformance relative to the U.S. equity managers is further illustrated in Table 4 below. Over the past 12 months, the U.S. equity portion of the MDP I portfolio has outperformed its custom benchmark by 0.67%, whereas the international equity managers have underperformed their custom benchmark by 5.97%.

Table 4 - Annualized Return Performance ending April 30, 2006[1]

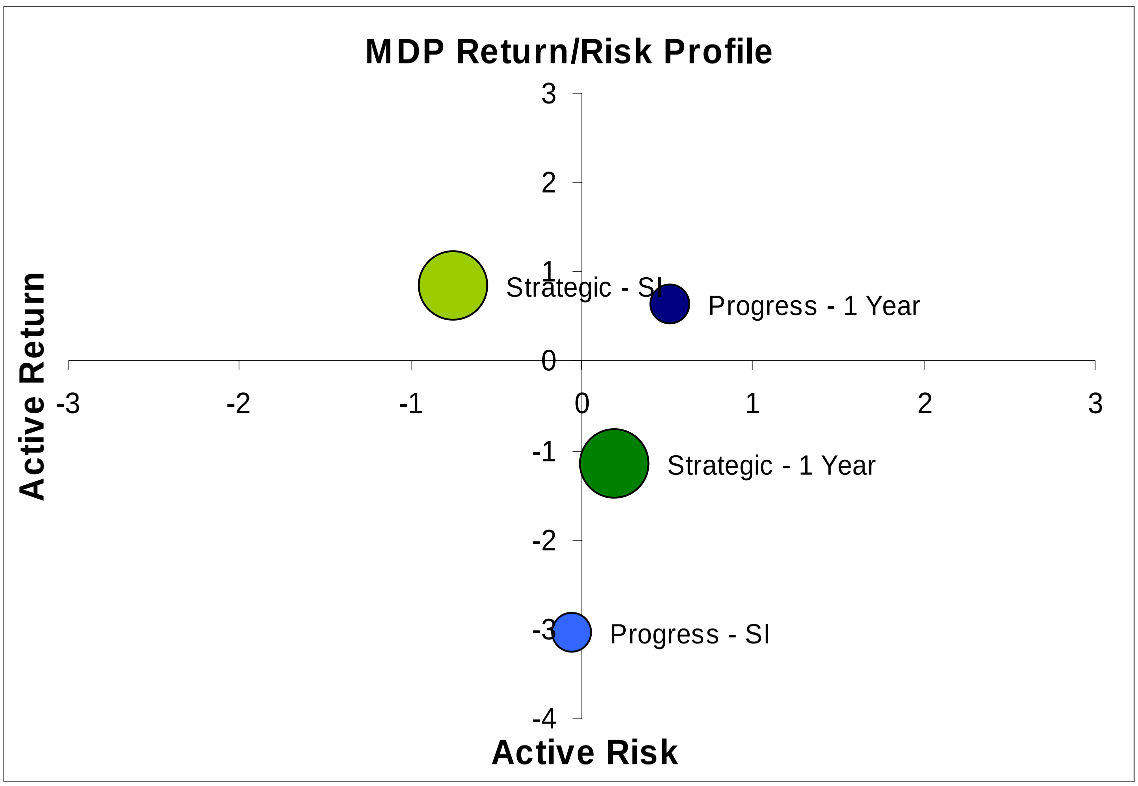
MDP Asset Class	% of MDP Portfolio	YTD 2006[1]	Calendar Year 2005	Last 12 Months[2]	Annualized Since Inception[3]
U.S. Equity Managers	75%	7.82%	6.98%	22.70%	3.56%
Custom Benchmark		7.88%	6.08%	22.03%	5.37%
Active Return		**-0.06%**	**0.90%**	**0.67%**	**-1.81%**
International Equity Managers	18%	15.35%	11.03%	29.35%	4.40%
Custom Benchmark		14.91%	15.08%	35.32%	5.80%
Active Return		**0.44%**	**-4.05%**	**-5.97%**	**-1.40%**
U.S. Fixed Income Manager	7%	-0.44%	1.37%	0.77%	5.82%
Custom Benchmark		-0.87%	2.57%	0.78%	4.94%
Active Return		**0.43%**	**-1.20%**	**-0.01%**	**0.88%**

[1] Performance is net of MDP firm management fees; [2] Through April 30, 2006; [3] U.S. performance inception date – 12/1/00; Intl performance inception date – 6/01/00; Fixed Income performance inception date – 3/31/02

It is important to note that given the structure of the MDP I, a manager graduation can have an adverse effect on the program's overall performance. Since the investment period is closed for MDP I, when better performing managers graduate from the program, additional managers cannot be added. As such, a larger percentage of the program is now allocated to the remaining managers in the program. These managers tend to be start-up firms which are still at the earlier stage of development and possibly need more time to work out performance issues. The implementation of MDP II will help mitigate this problem in the future as it was created with an open investment period in which additional managers can be added on an opportunistic basis.

Figure 1 plots the performance and risk of both MDP partners' portfolios over the past year and since inception through April 30, 2006. The size of the bubbles reflects the proportion of assets in each partnership as of April 30, 2006.

Figure 1



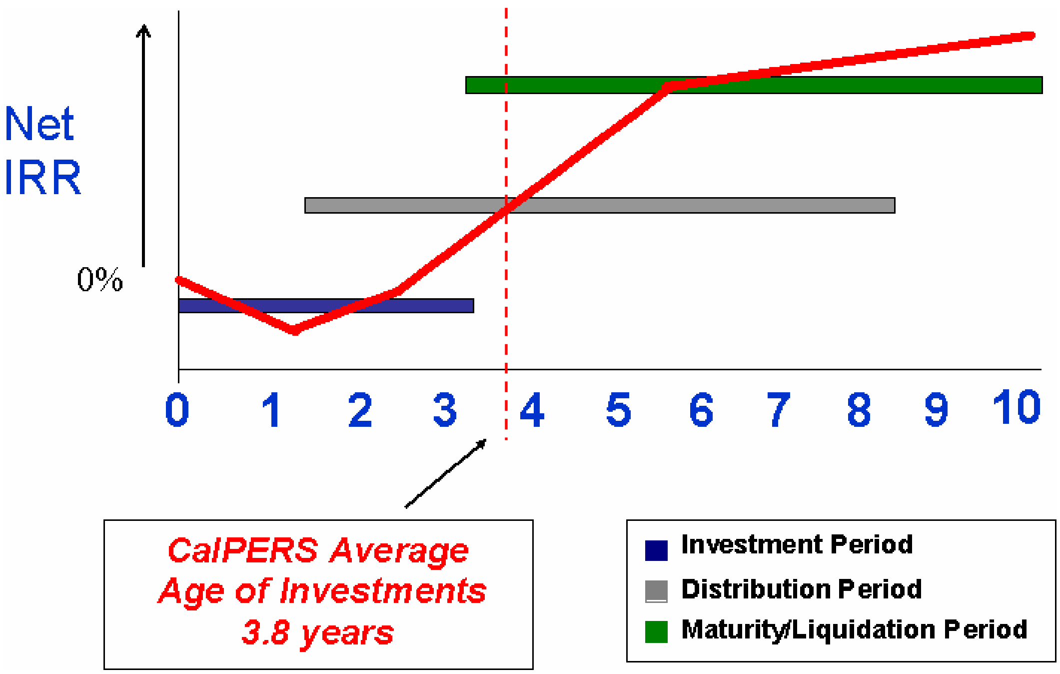
Progress' performance has improved over the past year without taking significant additional risk, whereas Strategic's recent underperformance is concentrated in the portfolio's international exposure. Strategic's long-term performance has outperformed its benchmark on a risk-adjusted basis.

Staff continues to work with both MDP partners to address underperforming managers and will continue to make the necessary adjustments to their respective portfolios. A number of actions have been taken to improve performance. First, one underperforming manager has been terminated and another graduated during the last twelve months. Additionally, assets have been re-allocated to better performing managers within the MDP.

MDP Partner Performance (venture portfolios)

Given the equity stakes that CalPERS obtains in each MDP firm, the venture portfolios of the MDP may experience the "J-Curve" effect, as illustrated in Figure 2. In the early years, the venture portfolios may typically experience low and negative returns. Over time, MDP firms and values increase resulting in unrealized gains above cost. In the final years, higher valuations are realized by the partial or complete sale of companies, resulting in cash flows to CalPERS and the MDP partners.

Figure 2 – Typical "J-Curve" effect



The private equity capital was invested throughout the various stages of an investment firm's life cycle. In addition, funds were allocated to firms at various time frames throughout the three year investment period. As such, the portfolio has a mix of both start-ups (early stage) and mature firms (later stage) and the average age of investments for the program is still early at only 3.8 years. By continuing to develop the early stage firms, it is the goal of the program to move these to the "mature" category within the next several years.

Tables 5 and 6 illustrate the mix of MDP firms for each MDP partner at the time of investment.

Table 5 - Progress Portfolio

Start-ups	Mature w/New Product	Mature Products/Firms
Arrowstreet	Smith Graham	N/A
Denali		
Shenandoah		

Table 6 -Strategic Portfolio

Start-ups	Mature w/New Product	Mature Products/Firms
Golden	N/A	LM Capital
Northroad		Pyrford
Rigel		Smith Asset
Stux		
Timeless		

Most of the MDP firms are making significant progress from a private equity perspective. Enterprise values are increasing due to firms gaining assets under management.

Table 7 illustrates the MDP private equity portfolio performance for each MDP partner.

Table 7 – Private Equity Portfolio

Partner	Dollar amount invested	Dollar amount distributed	Valuation[1]	Multiple of Cost	Net IRR[2]
Progress Lovell Minnick	$22.4 mil	$25.8 mil	$58.0 mil	2.6x	20%
Strategic Inv. Mgmt.	$ 8.5 mil	$27.2 mil	$44.2 mil	5.2x	49%

[1] *Valuation represents unrealized values plus any distributions received. Please note that valuations are based on trailing financial performance and are preliminary estimates given the short time-frame for the venture portfolios. However, realized valuations are audited by an independent outside party.* [2] *Performance is net of MDP partner management fees.*

Early private equity performance results are favorable given the short-time frame of the portfolio. Although the MDP private equity portfolio is still in its early stages, CalPERS has already realized two investments at a gross IRR return in excess of 20%. As of May 2006, CalPERS has recouped all of its capital contributions and management fees from both realized investments and ongoing cash distributions and continues to receive consistent cash distributions from a number of the managers in the program. In addition, 10 of the 12 firms in the MDP program have reached sustainable profitability levels, as portrayed in Attachment 3.

Section 3 – MDP I Individual Manager Performance

Progress Lovell Minnick

Progress invested $850 million of investment assets among eight firms, three of which have been terminated and one that has recently graduated. Progress' overall investment portfolio has improved as three of the remaining four firms have outperformed their benchmark over the past year.

Tables 8 and 9 illustrate the individual manager performance versus their benchmark. Table 8 shows the one-year period ending April 30, 2006. Table 9 shows the annualized since inception period ending April 30, 2006.

Table 8 – 1 Year performance ending April 30, 2006[1]

PROGRESS LOVELL MINNICK	Assets Under Management	% of Progress Portfolio	Manager Returns	Benchmark Returns	Active Returns
U.S. Equity					
Denali Advisors	$139,960,920	21.9%	23.59%	20.40%	3.19%
Shenandoah – MidCap	$147,022,937	23.0%	25.69%	28.32%	-2.63%
Shenandoah – SMID[2]	$27,386,049	4.3%	N/A	N/A	N/A
Smith Graham	$152,212,113	23.9%	16.66%	15.18%	1.48%
International Equity					
Arrowstreet - Intl	$171,300,096	26.9%	42.98%	37.43%	5.55%

[1] Performance is net of MDP firm management fees; [2] Recently funded on December 31, 2005

Table 9 – Annualized since inception performance ending April 30, 2006[1]

PROGRESS LOVELL MINNICK	Assets Under Management	% of Progress Portfolio	Manager Returns	Benchmark Returns	Active Returns
U.S. Equity					
Denali Advisors	$139,960,920	21.9%	6.96%	7.23%	-0.27%
Shenandoah - MidCap	$147,022,937	23.0%	11.53%	12.84%	-1.31%
Shenandoah - SMID[2]	$27,386,049	4.3%	10.73%	11.69%	-0.96%
Smith Graham	$152,212,113	23.9%	12.43%	15.46%	-3.03%
International Equity					
Arrowstreet - Intl	$171,300,096	26.9%	9.35%	6.18%	3.17%

[1] Performance is net of MDP firm management fees; [2] Recently funded on December 31, 2005

Figure 3 below plots the one-year performance and risk of Progress' managers as of April 30, 2006. Figure 4 plots the performance and risk of the managers since inception through April 30, 2006. The size of the bubbles reflects the proportion of assets in each manager as of April 30, 2006. As portrayed by the two charts below, most of the managers have improved performance over the past year without taking on additional risk.

Figure 3 – Progress Return/Risk Profile – 1 Year

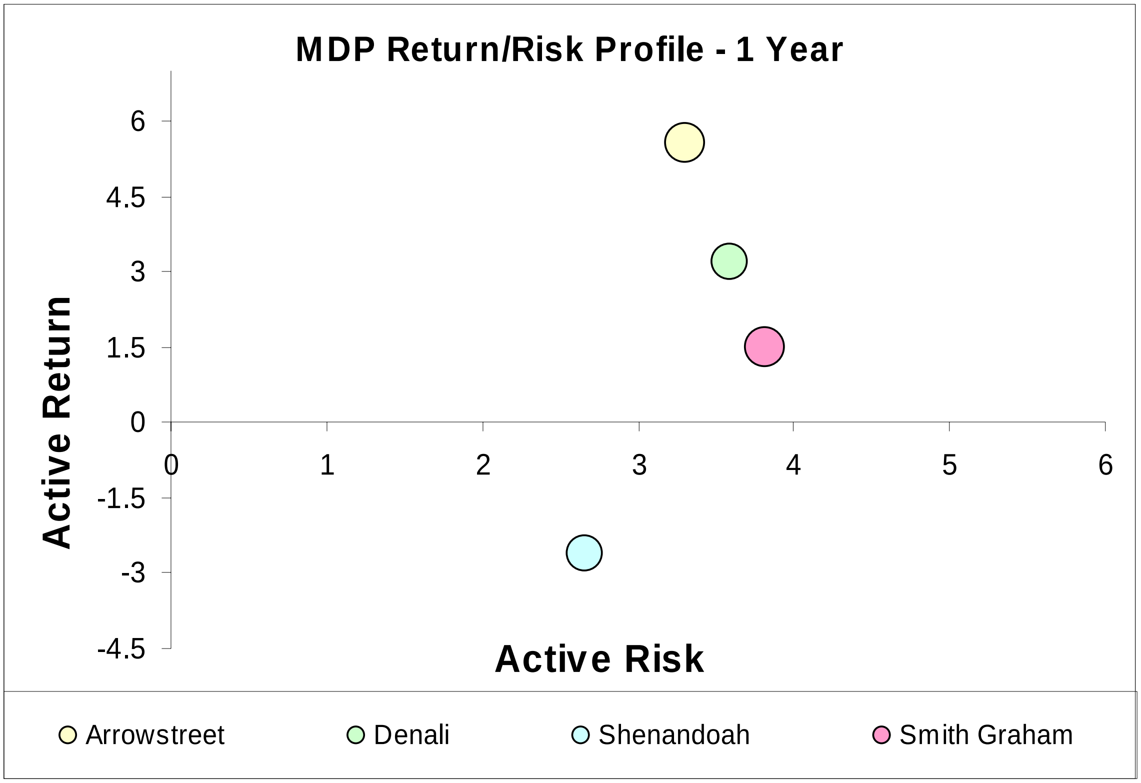
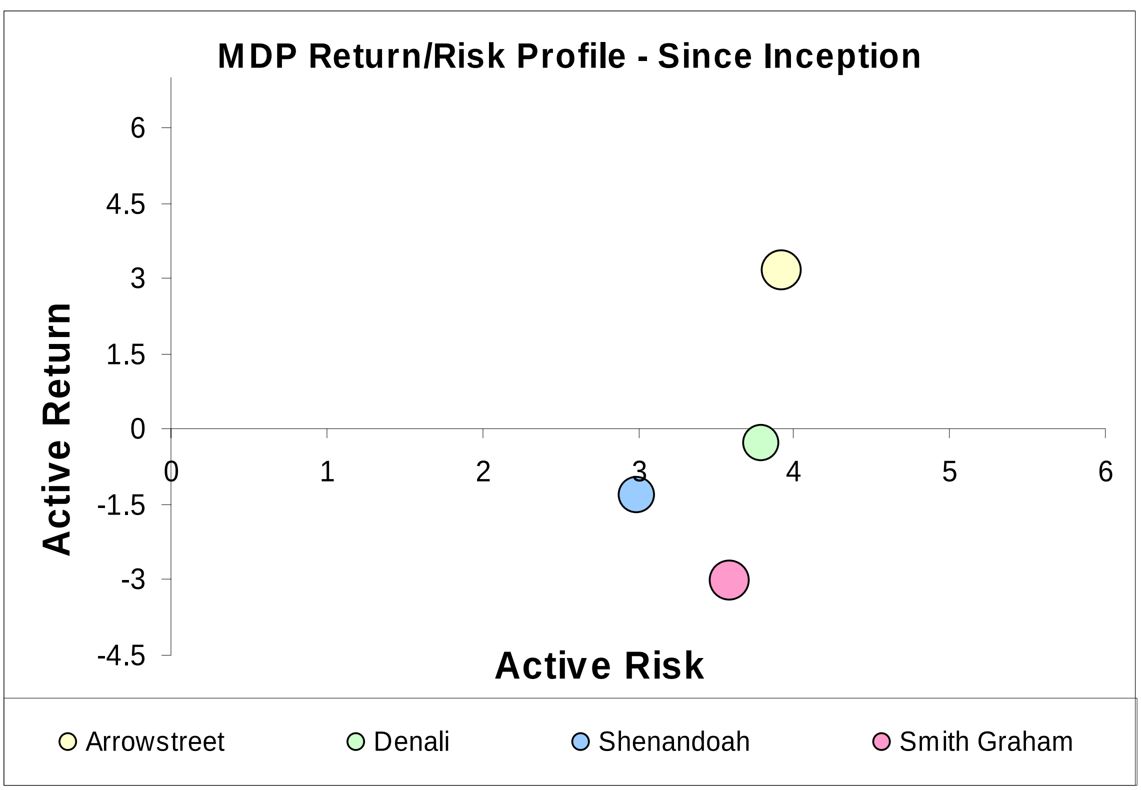


Figure 4 – Progress Return/Risk Profile – Since Inception



Strategic invested $1.65 billion of investment assets among eight firms and twelve products. Strategic's long term overall investment portfolio continues to perform within staff's expectations, with eight of the twelve portfolios outperforming their benchmark since inception. As noted earlier in this agenda item, most of the recent underperformance is attributed to the international exposure within the portfolio. Staff has reduced this exposure over the last 12 months from 32% to 15%, given that these managers tend to have more concentrated portfolios, which result in higher return volatility.

Tables 10 and 11 illustrate the individual manager performance versus their benchmark. Table 10 shows the one-year period ending April 30, 2006. Table 11 shows the annualized since inception period ending April 30, 2006.

Table 10 – 1 Year performance ending April 30, 2006[1]

STRATEGIC INVESTMENT MGMT	Assets Under Management	% of Strategic Portfolio	Manager Returns	Benchmark Returns	Active Returns
U.S. Equity					
Golden –Core Large Cap	$57,704,750	3.1%	17.10%	15.42%	1.68%
Golden –Core Small Cap	$144,576,401	7.8%	32.65%	31.39%	1.26%
Golden -Large Cap Value	$243,775,265	13.2%	18.64%	15.42%	3.22%
Rigel – Large Cap Growth	$195,807,181	10.6%	19.76%	15.18%	4.58%
Rigel – Small/Mid Growth	$68,933,978	3.7%	33.68%	34.07%	-0.39%
Smith – Large Cap Core	$216,887,908	11.7%	27.35%	15.42%	11.93%
Smith – SMID Core	$117,721,431	6.4%	29.68%	30.35%	-0.76%
Stux – Large Cap Core	$242,426,356	13.1%	15.83%	16.71%	-0.88%
Timeless – Small Cap	$100,365,650	5.4%	25.52%	33.47%	-7.95%
International Equity					
North Road Capital - Intl	$142,580,067	7.7%	27.04%	34.64%	-7.60%
Pyrford International - Intl	$136,415,115	7.4%	22.92%	34.64%	-11.72%
U.S. Fixed Income					
LM Capital	$179,483,149	9.7%	0.77%	0.78%	- 0.01%

[1] *Performance is net of MDP firm management fees*

Table 11 – Annualized since inception performance ending April 30, 2006[1]

STRATEGIC INVESTMENT MGMT	Assets Under Management	% of Strategic Portfolio	Manager Returns	Benchmark Returns	Active Returns
U.S. Equity					
Golden –Core Large Cap	$57,704,750	3.1%	3.43%	1.54%	1.89%
Golden –Core Small Cap	$144,576,401	7.9%	13.10%	12.58%	0.52%
Golden -Large Cap Value	$243,775,265	13.2%	6.19%	1.54%	4.65%
Rigel – Large Cap Growth	$195,807,181	10.6%	11.89%	7.72%	4.17%
Rigel – Small/Mid Growth	$68,933,978	3.7%	14.81%	15.67%	-0.86%
Smith – Large Cap Core	$216,887,908	11.8%	14.57%	11.22%	3.35%
Smith – SMID Core	$117,721,431	6.4%	17.33%	15.09%	2.24%
Stux – Large Cap Core	$242,426,356	13.1%	8.95%	9.58%	-0.63%
Timeless – Small Cap	$100,365,650	5.4%	16.18%	21.54%	-5.36%
International Equity					
North Road Capital - Intl	$142,580,067	7.7%	16.80%	22.04%	-5.24%
Pyrford International – Intl	$136,415,115	7.4%	13.67%	16.49%	-2.82%
U.S. Fixed Income					
LM Capital	$179,483,149	9.7%	5.82%	4.94%	0.88%

[1] *Performance is net of MDP firm management fees*

Figure 5 plots the one-year performance and risk of Strategic's managers as of April 30, 2006. Figure 6 plots the risk and performance of the managers since inception through April 30, 2006. The size of the bubbles reflects the proportion of assets in each manager as of April 30, 2006. With the exception of the international managers who underperformed over the past year, most have maintained or improved performance without taking on additional significant risk. As previously discussed, staff has taken steps to address the international performance.

Figure 5 – Strategic Return/Risk Profile – 1 Year

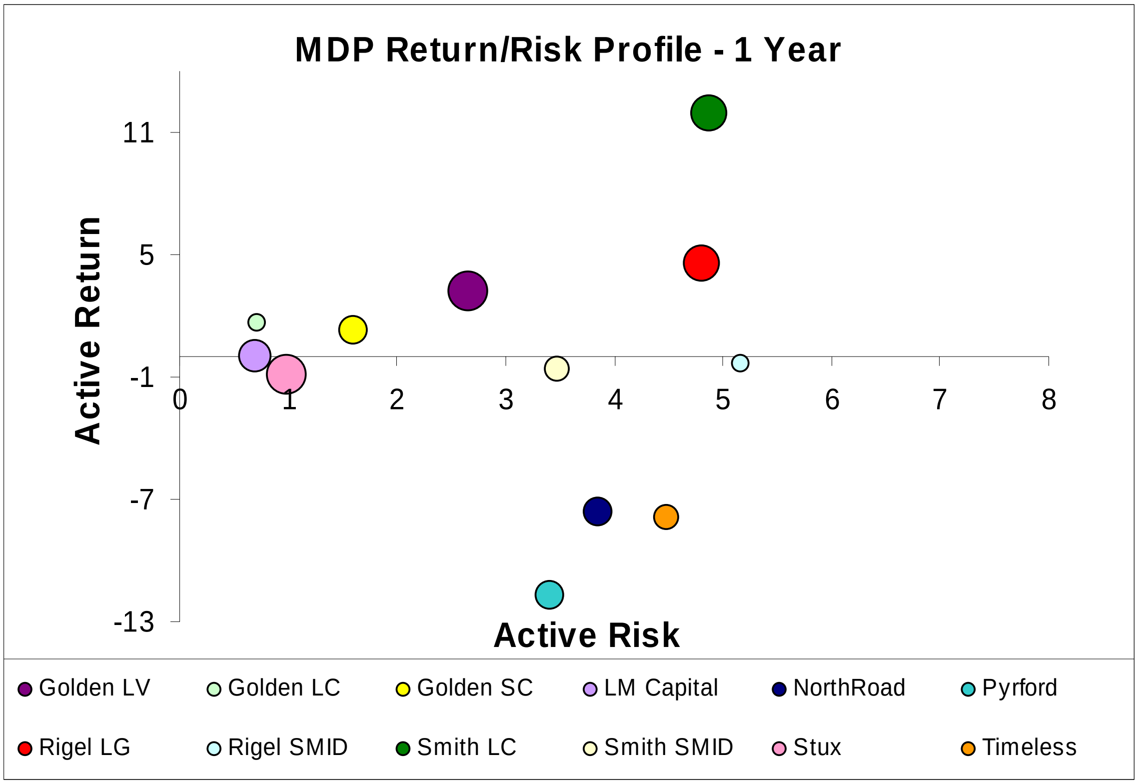
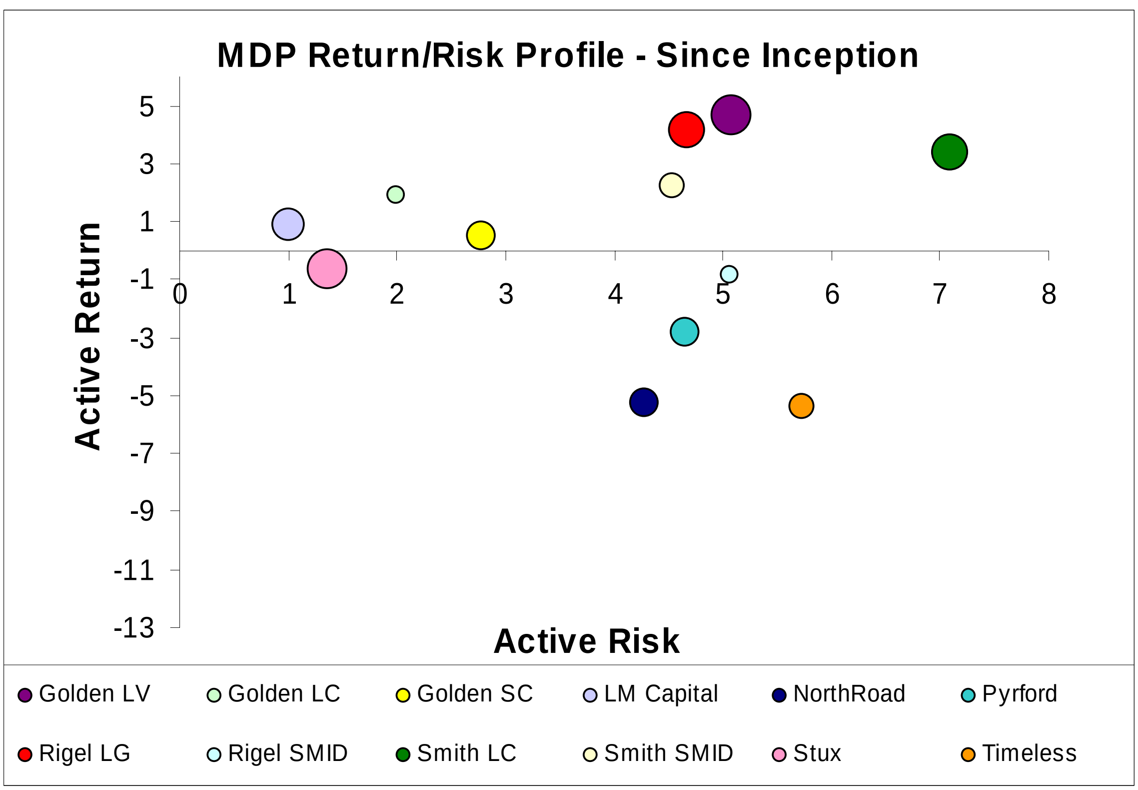


Figure 6 – Strategic Return/Risk Profile – Since Inception



More detailed descriptions of each firm, including CalPERS' ownership for each firm are shown in Attachment 2.

Section 4 - MDP II Update

At the June 13, 2005 meeting, the Investment Committee approved five firms for inclusion into the MDP II spring-fed pool of advisors: Bear Stearns, Legato Capital Management, Progress Investment Management, RockCreek Group, and Strategic Investment Management.

Staff has contracted with all five strategic advisors for the spring-fed pool; however limited liability agreements are being negotiated and signed one advisor at a time. At this time, staff has signed limited liability agreements with both Legato Capital Management and Strategic Investment Management. Legato will be an advisor to long-only emerging firms while Strategic will be an advisor to both long-only and hedge fund-of-fund firms. Staff may proceed with more advisors in the future. Initial due diligence from both advisors indicate there are numerous long-only candidates for MDP II exhibiting high quality and diversity. Staff anticipates funding three to five managers per year subject to the availability of qualified firms that both staff and the advisor believe will be successful.

In addition, staff may proceed with adding an additional firm to the MDP II spring-fed pool of advisors. With three of the five firms in the spring-fed pool focusing on long-only strategies, adding an additional long-only advisor would help broaden the pool such that CalPERS is not overly reliant on any one MDP II partner.

In contrast to MDP I, MDP II has the following enhancements: 1) MDP II Partner management fees paid on invested capital rather than on committed capital, 2) no specific commitment of CalPERS' capital to the program, 3) an opportunistic investment period, and 4) both staff and MDP II Advisor must agree on each investment. MDP II will continue to look at long-only international equity, U.S. equity, and high-yield fixed income emerging managers, but will expand its opportunity set to include emerging hedge fund-of-funds as well.

Summary

The MDP I program has completed the investment phase. The remainder of the program will be devoted to developing the current MDP I firms and preparing for the final phase: maturity and liquidation. Staff continues to work with both MDP I partners to address manager performance issues and improve the overall program performance. The MDP II program is now active and staff is currently reviewing potential MDP II candidates with the MDP II strategic advisors. To date, staff has not yet funded MDP II firms, but will keep the Investment Committee informed of MDP II firm selections.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and, second, to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

The purpose of this item is to keep the Investment Committee informed of the progress and performance of the Manager Development Programs I and II.

Melissa Paminto Investment Officer	Richard Duffy Investment Officer II
Derek Hayamizu Portfolio Manager	Mary C. Cottrill Senior Portfolio Manager
Christianna Wood Senior Investment Officer	Russell Read Chief Investment Officer